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June 5, 2000

Mr. Vernon Williams
Secretary
Surface Transportation Board
1925 K St. N.W.
Washington, D.C. 20423-0001

Via Hand Delivery

Dear Mr. Williams:

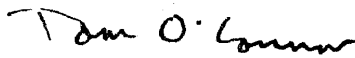
Enclosed, for filing in Ex Parte 582 (Sub-No.1), Major Rail Consolidation Procedures, are the Reply Comments of BASF Corporation and the accompanying Reply Verified Statement of Tom O'Connor.

We have provided the original and 25 copies of the filing, as well as an electronic version in WordPerfect 7.0.

We would appreciate it if your staff would date stamp the second copy of this letter for return to us. Should questions arise, please call me at (202) 371-9149.

Thank you.

Sincerely,


Tom O'Connor
Vice President



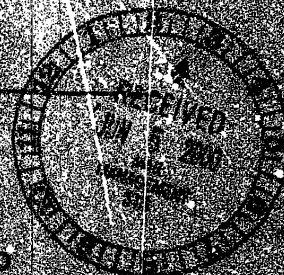
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ORIGINAL



**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 582 (Sub No. 1)

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**Office of
Public Hearing**

MAJOR RAIL CONSOLIDATION PROCEDURES

REPLY COMMENTS OF BNSF Corporation

And Reply Verified Statement of

Tim O'Connor

Shenely Ring-Majors & Connor & Co., Inc.

1220 L St. NW

Washington, DC 20005

Dated June 5, 2000

Ex Parte No. 582 (Sub No. 1) June 5, 2000

BASF Corporation

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 582 (Sub No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REPLY COMMENTS OF BASF CORPORATION

Ex Parte No. 582 (Sub-No. 1) June 5, 2000

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 582 (Sub No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REPLY COMMENTS OF BASF CORPORATION

BASF Corporation, by Counsel, respectfully submits these comments in response to the Surface Transportation Board's (Board or STB) decision of March 17, 2000 and its Advance Notice of Proposed Rulemaking (ANPR), served March 31, 2000.

BASF Corporation (BASF) is a transnational corporation and a major shipper of chemicals and chemical products by rail. BASF operates a fleet of more than 4,000 rail cars that last year carried four billion pounds of product in some 22,000 outbound shipments. BASF is therefore vitally concerned that further railroad mergers be considered in light of the short and long-term impact on rail shippers and the consuming public.

In our comments we survey the responses of many of the parties to the proceeding in much the same way the Board may. We apply reasonable tests to the positions offered and reach conclusions as to which recommendations lead further towards problems such as encountered in the most recent two mergers and which lead back to balanced and competitive mainstream solutions.

Downstream Effects

As pointed out in Mr. O'Connor's statement, with the notable exception of the two railroads currently seeking to merge, virtually every party commenting on this issue favored the STB's proposal to consider downstream effects. Like BASF, most parties agreed with the STB that the likely outcome of any additional merger will be a consolidation of the industry into two transcontinental and transnational Class I railroads.

Even among the Class I railroads, there is substantial support for considering downstream effects. Four large Class I railroads all supported abandonment of the one-at-a-time rule, but the Class I railroads seemed uncertain how to integrate downstream effects other than consolidating contemporaneous merger proposals.

We found a general consensus among the non-railroad parties that the bar should be raised regarding preserving public interest benefits of further mergers, and more to the point, avoiding further repetitions of the disastrous disorder flowing from the two most recent mergers. Mr. O'Connor terms this growing consensus a "sea change" in the positions of many respondents. Party after party pointed to the

utter failure of the UP/SP and the NS-CSXT-CR mergers to yield the promised benefits. In fact, the two most recent mergers, UP/SP and NS-CSXT-CR, led to serious deterioration in service quality.

We note that this inability to deliver the promised benefits has not been for want of skill and experience on the part of the involved railroads. Capable people were on both rail merger teams. However, we appear to have reached a point where, besides the loss of competition, two to three years of service collapse is part of the price of a major rail merger. We find that price too high. Significant change in the process is required if further mergers are to be attempted. And this additional price must be factored into the STB's pre-merger review process.

In fact, two US Cabinet Departments question the advisability of any further mergers of Class I railroads. They point out that end-to-end mergers, virtually the only kind of merger remaining, yield little in efficiency benefits, and are likely to reduce intra-rail competition. USDA therefore proposes that the Board adopt a "rebuttable presumption" against any further mergers.

Other parties are emphatic that end-to-end mergers will not be in the public interest. They note that without changes in the STB's "lump sum" and bottleneck policies, these types of merger are certain to reduce competition. As stated in Mr. O'Connor's Opening and Reply Statements, we agree with this observation and have recommended changes in both of these policies.

Many respondents urge the Board to require any merging railroads to demonstrate very significant efficiency benefits. These benefits would have to be shown to be so great that they outweigh the evident harm to the public interest in reducing intra-modal rail competition.

In summary, we believe STB should consider the recommendation of the USDA regarding future major railroad mergers, where the merging railroads would:

- come up with a plan that mitigates any adverse consequences of the merger upon shippers and other railroad firms,
- prove the existence of merger-related benefits, and
- demonstrate that those benefits cannot be achieved by other means short of merger.

Competition

Like BASF, most parties commented on the ANPR's suggestions on how competition might be preserved or enhanced.

1. Maintenance of Gateways

Virtually every party addressing the issue, including all of the railroads, supported the requirement that merging applicants should maintain open gateways for all major routings. This rare example of unanimity clearly calls for a policy decision by STB.

2. Reciprocal Switching and Interswitching

Not surprisingly, we found no such unanimity on the issue of reciprocal switching. Virtually all shippers and shipper groups agreed with us that something like the Canadian concept of "Interswitching" should be adopted. Most proposed that it be applied universally in the immediate surroundings of any interchange point between railroads. Some thought the switching rate should be negotiated if possible. If agreement is not forthcoming, most shippers favored an arbitrated resolution.

Perhaps, reflecting its time honored status as a proven and efficient operating technique, and the widespread use of the reciprocal switching concept, railroad respondents did not dispute its effectiveness, but rather argued that it is not a merger-related issue. This view fails to recognize the Board's stated objective of not just preserving competition, but enhancing it. The railroads may have a point that a requirement for Interswitching imposed only on applicant railroads would be asymmetrical, but given the need to consider "downstream effects," there is logic in the Board's considering this proposal in the context of its review of merger guidelines. If the remaining major railroads will eventually merge (which is very likely to happen if the first two merge), then the competitive relationship of all the merging railroads must be, and can be, considered now, not after the transcontinental duopoly develops.

Some shortline railroads objected to reciprocal switching because it threatens their markets. With reciprocal switching, a major railroad could offer a

through rate that would render uncompetitive an interchange movement in which the short line railroad participates. A solution to this problem lies in the negotiation or arbitration of the switching charge. Presumably, the shortline railroad will participate in this negotiation, and can make its case for a compensatory rate there. The Canadian concept of prescribed Interswitching rates, set equitably for both shipper and railroad offers a solution. Exempting some railroads, such as shortlines, based on preserving their interests would be an unbalanced approach, inequitable to the involved shippers.

3. Bottleneck Rates

The ANPR proposes that the Board might require merger applicants to offer, upon request, contracts for the competitive portion of joint-line routes when the joint-line partner has a bottleneck segment. We see at least two potential problems with this proposal.

The first was raised by DOT, which argues that the Board exceeds its authority in requiring a railroad to offer a contract rate. We do not believe this is a valid objection. While the DOT point is probably valid in a non-merger context, it is widely recognized that the Board has broad authority to prescribe conditions for mergers that go beyond its conventional regulation of rates. Additionally, the rate need not be a contract. It could be a tariff rate applicable to the specific commodity and point-pair of the shipper. The objective to be served is to isolate the competitive rate from the bottleneck rate, and this should be possible under existing Board authority.

A much more fundamental problem with the Board's bottleneck rate procedure is that it does not solve the problem. There are two reasons for this, both of which are widely recognized. (See for example the discussion in the Initial Comments of the NIT League.) First, the application of the Board's bottleneck policy has been so restrictive that, to our knowledge, no shipper has ever realized any relief from it. It scarcely benefits shippers to allow them to challenge a bottleneck rate if the standards for relief are so demanding that they cannot be met. Thus, a precondition for enhancing competition through bottleneck rate relief is a reconsideration of the burden of proof borne by the shipper to demonstrate that a rate is unreasonable.

Secondly, the Board procedures to isolate the bottleneck rate from the competitive rate do not benefit the shipper if an end-to-end merger creates a single-line route. As Mr. O'Connor pointed out in his Opening Verified Statement (OVS), the current bottleneck rules would permit the carrier lawfully to preclude competition from other carriers that might exist over other segments of the route. This misguided application of the Board's policy, greatly exacerbates the anti-competitive effects of end-to-end mergers, as Mr. O'Connor also pointed out in his OVS. These simple facts reinforce our recommendation that the Board revise its treatment of bottleneck rates.

The solution, supported by us and numerous other respondents, including DOT, is to remove procedural hurdles to implementing bottleneck rate relief. We recommend reasonable procedures that permit shippers to request and receive

separate rates on the bottleneck portions of their movements. Shippers must be allowed to examine those rates and challenge them, if necessary, under revenue-to-cost ratio standards that permit the carriers to maintain reasonable revenue levels without extracting unreasonable monopoly rents from captive shippers.

4. "One-lump" Theory

The one-lump theory holds that there is some fixed amount of monopoly profit that can be extracted from any movement. If, prior to a merger, a portion of the movement has been monopolized, then the theory asserts that monopoly profit has already been extracted. According to the theory, the effect of extending the monopoly to the entire movement (or to a larger portion of it) is neutral to the shipper. Again in theory, the shipper experiences no difference in monopoly pricing after the merger, as compared to before it. In practice, Mr. O'Connor has found the railroads often do attempt to extract additional revenue when competitive choices are eliminated.

Our experience bears out the NIT League statement, that the "one-lump" doctrine is a triumph of theory over evidence. Mr. Tom O'Connor has personally assisted in negotiating many rail rates over the years, and is familiar with the process from both the railroad perspective and the shipper perspective. In the attached Verified Statement, he observes that the leverage of the shipper is very closely linked to the availability of competition. Contrary to the one-lump theory, loss of competition at the origination point is an ongoing hindrance in seeking competitive rate and service agreements. And the availability of competitive rail

options greatly enhances the likelihood of competitive rate and service agreements. Mr. O'Connor has observed that this holds for a wide range of competitive alternative situations occurring subsequently in the route, theory notwithstanding.

The one-lump theory is based on the unrealistic premise that the pre-merger rate for the monopoly portion of the movement is a perfect monopoly price, while that for the competitive portion is independently derived by market competition. This assumption overstates both the pricing acuity of the railroads and the effectiveness of rail competition. In fact the pre-merger monopoly railroad can only guess how high it can set the price for its piece of the through rate without stopping the movement altogether. Furthermore, despite its pricing power, the railroad does not control the price on the competitive piece of the movement. It therefore cannot be sure its rate is as high as the market might allow. Hence the ongoing pressure for higher rates, which is quite evident in the rail market today. Once competition disappears through merger, railroads often renew their effort to extract additional profits from the movement.

Disposal of the one-lump theory would lead to the resolution we recommended in our initial comments. We recommend preservation of competitive alternatives wherever they exist currently; and where they cease, the obligation for a quote from the dominant railroad for a challengeable bottleneck rate to the

nearest interchange point; and even challenges to bottleneck rates in some existing situations¹.

5. Other Competitive Solutions

Most of the other proposals to enhance competition are variants on the concept of limited open access. They involve such strategies as trackage rights, haulage rights, joint access areas, and similar operational solutions. These conditions would materially change the relationship between railroads and the shipping public. While we support most of these proposals, we also recognize that they suffer from limitations in the Board's authority. The Board might be able to impose them as merger conditions, but if applied only to the merging railroads, they might disadvantage those railroads vis-a-vis non-merging railroads. Moreover, as pointed out in Mr. O'Connor's OVS, these operational solutions vary in effectiveness, in part because they vary in degree of operational control granted by the party conferring the trackage or haulage rights.

Service Quality

Overwhelmingly, the respondents recognized the service shortcomings of recent rail mergers. Indeed, those service difficulties constitute a principal

¹ For example, we view with dismay and concern the prolonged and expensive legal battles that were required to secure the recent favorable decisions in the FMC case. We see simplification of such processes as a compelling need.

argument against the approval of further mergers: the railroads become too big to manage and too big to allow to fail. Most parties recognized that if further mergers are to proceed, maintenance, if not improvement, of service quality must be addressed far more effectively than in the past. The parties' positions can be classified into three broad categories: pre-merger planning, merger implementation, and redress by shippers after the merger.

1. Pre-merger Planning

Virtually every party commenting on the issue insisted that the merging railroads must submit a detailed plan describing how the operations of each railroad will be combined so that service levels will be maintained or improved. These plans, which go by various names such as "Transitional Service Plans" (DOT) and Service Integration Plans (California PUC), generally require the applicants to explain how they plan to merge their respective operations in light of the litany of service problems following recent mergers. DOT recognizes that government agencies do not have the expertise to evaluate such plans, so it recommends that interested parties should be allowed to review and comment on these plans.

DOT also recommends that the Board require the applicants to submit contingency plans in the event that service breakdowns occur as part of the merger process. These plans would cover key corridors and yards where there would be a significant change in operations or traffic volumes.

Critical to the merger plans would be the metrics by which performance would be tested. Many measures are available. For example the California PUC lists eight service performance standards.

Section 1180 of the Board's rules contain an extensive list of information and data that merging railroads are already obliged to submit with their applications. While additional items might be added to this list, the simple filing of the information is no guarantee of effective implementation. The key is to plan early, proceed in measured stages and apply measures that are meaningful from the rail customer's perspective, not solely the railroad perspective. Mr. O'Connor and many other respondents made this point in the Opening Statements. We see performance standards as a very important part of the solution, and a part that has been underutilized. In both our Opening and Reply Statements we discuss specifics of our recommended solution.

We believe more detailed planning will not be sufficient to solve the problems. We believe a change in the process is needed. As noted above, the railroads need to plan early, proceed in measured stages and apply performance measures that are meaningful from both the rail customer's perspective, and the railroad's perspective.

We are familiar with both the people and systems now used by the merging railroads. The people are among the best rail planners and the systems are similarly well developed. Further refinement there is not the answer. A new procedural structure is required with well-defined stages of process development

and feedback before advancing to the next stage, as pointed out by Mr. O'Connor in both the Opening and Reply Statements.

Implementing rail mergers calls to mind a military concept termed the "fog of war" describing rapidly changing operational situations, limited information and the need for a stream of inter-related decisions. Proceeding with a well-defined and phased operation can eliminate many of these problems

2. Merger Implementation

In our view, many of the parties commenting on the problems of merger planning and integration fail to recognize that there is a "Catch 22" problem confronting the Board. The applicant railroads are asked to formulate plans for their merger before the merger has taken place. That seems reasonable, but the most recent two mergers demonstrated that highly skilled and experienced planners and operating managers on the merging railroads were not able to anticipate the problems they would encounter until they actually merged. However, they could not merge until given the Board's authorization to do so. The Board is thus asked to approve merger plans that are incapable of accurate definition until the merger is under way. By then, the Board has already approved the merger, and too often, we have "crossed the Rubicon."

In Mr. O'Connor's Opening and Reply Verified Statement he recommended a Three Phase Merger Approval Process: corporate, business and operational. We again commend this to the Board's attention. First, there is the corporate phase of

the merger, when the two entities are combined into a common company. To approve this initial step, the Board must accept the overall concept of the merger based on a public interest demonstration by the applicants. As noted earlier, the applicants could be required to overcome a rebuttable presumption against the merger. The test for this phase of the approval process must therefore be one of proven and real public benefit.

Assuming the applicants pass that test, they would be allowed to merge their headquarters, but not their field operations. The two rail systems would continue to operate independently. At this point, now that the two companies are combined, they are in a position to develop a plan for their operational merger. That plan, which is similar to the plans recommended by parties such as DOT and the California PUC would be submitted for approval in the second phase of the merger, the business merger. The Board would then hold hearings, receive comments and evidence, and render a judgement on the suitability of the plan for the merging of the two systems.

The two systems would not yet be merged at the operating level, however, because the applicants have yet to prove that their systems are sufficiently integrated to operate without service difficulties. During the third and final phase of the merger approval process, the integrated systems, such as car supply, train control, customer ordering, billing and rate integration, would be tested under real-life simulated conditions, possibly using trial field operations. Again, the results of the tests would be made available to interested parties, who would have the opportunity to comment and, if necessary, hearings could be held before the Board.

The Board would then render its third and final approval of the merger, that for an operational merger.

DOT has also recognized the need for a "staged implementation." It refers to the implementation as more of an "assimilation than a takeover." DOT does not appear to call for separate, phased approvals by the Board, which we are recommending; but such would be consistent with its proposal. DOT would have the applicants establish the implementation schedule, which might be acceptable, but the content of the information and tests prior to the approvals should not be left to the applicants' discretion. Unfortunately, the record of recent mergers detracts from the level of trust that can be placed in railroads' judgement in matters of preserving service quality. Broader review and involvement at the three stages of development can help remedy this problem.

3. Post-merger Redress by Shippers

A common theme from virtually all shipper parties is that the principal victims of post-merger service breakdowns have been not the railroads, but the shippers. While shippers have sought compensation for some of the losses suffered at the railroads' hands, there has been no pre-determined plan for the recovery of those losses.

In response to this problem, respondents have proposed a host of solutions. These include the creation of an escrow account for shipper compensation,

enforceable contracts for pre-determined levels of service, and additional explicit measures and agreements.

At this point, the Board does not necessarily have to select among these alternative plans. It need only establish in clear and unmistakable terms that merging railroads will be held liable for any shipper losses that result from merger-related problems. Shipper losses are defined as any level of service that is less than that received from the pre-merged railroad.

Summary

BASF reaffirms the positions we took in the Opening Comments.

I. The Board Must Anticipate that Any Further Mergers Will Lead to a Transcontinental Rail Duopoly.

BASF supports and applauds the Board's conclusion that further rail mergers cannot be considered on a case-by-case basis under rules that were adopted following the Staggers Act of 1980. Correctly, the Board points out that it must consider "downstream" effects, including the likely strategic responses of the non-applicant carriers.

In his OVS, Mr. O'Connor, and other respondents, discussed the nature of competition in a duopoly, where competition tends to be limited, because each duopolist has an interest in the survival of the other. He concluded that there would

be limited and sparse rail-to-rail competition. Moreover, most shippers would have access to either one or the other of the two transcontinental or transnational systems.

If this is the future of the rail industry, then the Board should anticipate that fact and design a responsive plan now. In the short term, the Board should adopt policies that preserve whatever intra-modal competition now exists, and it should identify ways to protect shippers who lack access to such competition. In the longer run, the Board should consider whether it may be appropriate to modify the structural arrangements within the railroad industry to allow new forms of competition to develop.

II. In the Short Run, the Board Must Prescribe Merger Terms that Protect and Expand Competition.

Appendix B to Mr. O'Connor's OVS showed BASF service locations that will experience a reduction in competition and some of those that are already served by only a single railroad. Unfortunately, the majority of BASF locations fall into this last category.

The ability to reach competing lines would be enhanced by a requirement for reciprocal switching for all shippers located within the switching limits of any local area served by two or more rail carriers. This arrangement effectively opens rail service within the local switching area to rail competition, regardless of the line on which any one shipper is located. The Canadians, who have lived with a rail

duopoly for most of their history, have just such an arrangement. Termed "Interswitching"; it enables shippers with access to only one carrier at origin or destination to gain access to another railroad if the shipper is located within a 30-kilometer radius of an interchange point.

Another Canadian technique for promoting competition is called "Competitive Line Rates" (CLR). Any captive shipper sending traffic over a route that can be served by more than one railroad is entitled to a rate from the captive (origin or destination) point to the nearest point of interchange with the alternate or connecting carrier. However, the shipper is required to first negotiate with the connecting carrier for the competitive portion of the movement. This impediment, reminiscent of the STB's current bottleneck rate regulations, has effectively removed CLR as an active remedy.

BASF respectfully recommends to the Board these and similar procedures, as specified in Mr. O'Connor's Opening and Reply Verified Statements, as critical to preserving and enhancing rail-to-rail competition in an ever-consolidating industry.

III. The Board Must Alter Its Practices to Protect Shippers from Bottleneck Pricing Abuse.

Most of BASF's shipping points are already captive to a single rail carrier. As a result, the forces of competition are unable to exert effective constraint on the market power of the railroad. BASF, and shippers like it, need help.

Even if there are competitive routes, the dominant carrier is often able to impose unreasonable charges for the captive, or "bottleneck" portion of the movement. Unless the non-bottleneck portion of the shipment is under contract, current Board practices do not allow shippers to challenge the bottleneck portion of the rate. The shipper must address only the total origin to destination charges. Yet, it is the bottleneck, which the shipper cannot avoid, and cannot address, that drives up the cost of the movement.

BASF urges the Board to modify its practices to allow shippers to challenge the reasonableness of the revenue levels of the captive portions of their movements.

IV. The Board May Ultimately Have to Consider Restructuring the Railroad Industry.

Mr. O'Connor's OVS contained descriptions of recent structural changes in the telephone, natural gas and electric utility industries that have brought competition into activities that for decades were considered the monopoly preserve of the incumbent providers. The prevailing principle in each of these restructurings has been open access. The principle of open access requires the incumbent to permit unrelated and sometimes competing entities to use its line facilities. In each case, the incumbents have regarded open access as an intrusion into their proprietary sphere. Yet, in each case the incumbents ultimately benefited from the restructuring, as did the consuming public.

BASF respectfully submits that the time is coming for the Board to consider the public interest benefits that might be derived by applying the principle of open access to the railroad industry. Particularly if the industry shrinks to two major systems, the present structural model, whereby each railroad carries its own trains and its own traffic at its own rates cannot be considered as economically efficient. We recommend implementing now the limited open access remedies discussed above and in Mr. O'Connor's statement. Failure to do so could force more draconian remedies later.

On that point, if the Board allows further mergers to proceed, it should now serve notice on the railroad industry that it may consider major structural changes as part of its agenda during the coming years.

V. The Board Should Address both Substantive and Procedural Aspects of the New Merger Guidelines

To succeed in meeting the challenges, the new merger guidelines must be designed with a view toward both substantive equity and procedural equity. It is possible to design seemingly equitable procedures that generate little, if any, real benefits. Indeed they may produce no results at all.

We suggest that the STB consider ways to improve upon the slow and unproductive course of well-intended but ultimately fruitless proceedings that have occasionally occurred in the past. The non-coal maximum rate reasonableness guidelines for small shippers comes to mind. These guidelines, when they are

BASF Corporation

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finally produced, could provide widespread benefits. It is commendable that the proceeding is underway. It would be better if it had produced practicable procedures and equitable results.

BASF Corporation

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We urge the STB to ensure that the Ex Parte 582 proceeding remains based on solid principles and facts and moves toward practical and equitable procedures.

Respectfully Submitted

Gene Striffler /cwic

BASF Corporation, by

Eugene Striffler, Jr.

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Before the Surface Transportation Board

**Reply Statement
On Selected Issues in
STB Ex Parte No. 582 (Sub-No. 1)
Major Rail Consolidation Procedures
Filed on Behalf of
BASF Corporation**

REPLY VERIFIED STATEMENT OF

**Tom O'Connor
Vice President
Snavelly King Majoros O'Connor & Lee, Inc.
1220 L St NW
Washington DC 20005**

June 5, 2000

**Verified Statement of Tom O'Connor
Ex Parte No. 582 (Sub-No. 1)**

SK Snavely King Majoros O'Connor & Lee

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Economic and Management Consultants

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Verified Statement of Tom O'Connor

Ex Parte No. 582 (Sub-No. 1)

I. EXECUTIVE SUMMARY

My name is Tom O'Connor. I am Vice President of the economic and management consulting firm of Snavelly King Majoros O'Connor & Lee, Inc. I have served as an economist with the ICC, the USRA, Conrail, the AAR and two consulting firms, including my present firm.

I previously provided testimony in this proceeding on behalf of BASF Corporation. In my Opening Verified Statement (OVS) I reported the results of analyses through which we developed, in collaboration with BASF, recommendations on rule revisions designed to retain, and enhance intra-modal rail competition. In preparing this Reply Statement, BASF requested that I review the filings made by others in this case and report the findings.

BASF is a transnational chemical company that manages a fleet of more than 4,000 rail tank and hopper cars from a centralized Rail Fleet Command Center. BASF applies sophisticated supply chain management techniques to minimize transit times, inventory levels and costs to itself and its customers. BASF, like most rail shippers has been forced to contend with massive service disruptions in the wake of recent mergers.

My OVS on behalf of BASF focused on three major improvements in the merger process:

- (1) recognition of downstream effects,**
- (2) promoting and enhancing competition, and**

Verified Statement of Tom O'Connor

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(3) maintaining efficient rail service.

Review of the record has identified overwhelming support for these and similar measures. The unifying characteristic of these measures is that they provide greater weight to the public interests and the interests of rail shippers, especially shippers like BASF who have limited transportation options.

The breadth and diversity of support for these measures is itself instructive. Railroads, Government Agencies, Shippers and others, many of whom were battered by the adverse consequences of recent rail mergers are coming to the same conclusions. Those conclusions can be summed up in four points:

1. Rail mergers have achieved the goals of system rationalization and efficiency improvement, which motivated the Staggers Rail Act of 1980.
2. Beginning with the UP/SP merger and continuing with the NSC-CSXT acquisition of Conrail, rail mergers have caused declines in efficiency, income and productivity. Much of this decline is directly attributable to diminished competitive alternatives.
3. The availability of competitive alternatives enables the market to operate efficiently and to achieve gains for all. The loss of competition leads predictably to losses in efficiency and productivity, which are sustained widely in the marketplace.
4. It is no longer the case that rail mergers should be presumed to be engines of efficiency. This can be remedied only by designing them or conditioning them to

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enhance and promote competition. The regulatory process needs to be modified now so that it enables the competitive energy to be applied in the marketplace.

In this statement we review the regulatory adjustments in terms of their ability to facilitate market processes and to do so effectively and efficiently.

Among the most effective are the three we recommended in our Opening Statement:

A. Downstream Effects

We recommend that the STB recognize and remedy the fact that further rail mergers will inevitably lead to duopoly. STB will need to strengthen the weakened intra-modal competition that will result from such duopolies. If simpler measures fail, structural changes such as those that took place in the telephone, natural gas and electric utilities industries would be adaptable to the rail industry to create effective competition.

B. Competition

With respect to competition, in the Opening Statement we explored several policy options available to the STB.

1. Maximum Rate Regulation

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2. Changes to the Bottleneck Rate Situation

- *We strongly recommended, as did numerous other parties, that the STB revise its practices to allow shippers to challenge bottleneck rates and charges specifically. The problem with the current procedures is that they simply do not work.*

3. "Build In" of Competing Rail Lines

4. Unlimited Open Access

5. Limited Open Access Solutions

- *We recommended, as did many other respondents, that limited open access approaches be adopted aggressively as conditions for future mergers. These are remedies with proven effectiveness which are already within the STB's regulatory authority*

C. Service

A primary consideration for many rail shippers, particularly those with limited non-rail options, like BASF, is the quality and reliability of rail service. The definition of rail service is a straightforward task. Many of the respondents observed accurately that the relevant dimensions of service are known and measurable. The process of producing rail service also relies on well-defined technology known widely throughout the world. The remedy then would seem to be equally straightforward:

- Measure the process; identify the variance from target; correct it.

Verified Statement of Tom O'Connor

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The role of regulatory policy is simply to establish a coherent framework within which this can occur. That leads us to a sixth policy option, also readily available to the Board: merger oversight.

Merger Oversight

- *We recommended, as did many others, that the STB set operating benchmarks before the merger based on normalized pre-merger performance, and refine the benchmarks to detect shortcomings at the regional and local, as well as system, levels.*
- *We also recommended a 3 Stage Merger Approval process to prevent further difficulties with service problems that planning is unable to foresee.*
- *To assure a factual basis for these remedies, particularly merger oversight, we recommend that the STB require uniform reporting of operating and financial data and common levels of disclosure for both U.S. and Canadian railroads involved in mergers.*

As this Reply Verified statement shows, the problems are well understood, reasonable solutions are well defined and the authority to apply such solutions is either already at the Board's disposal, or could be readily requested.

While many of the underlying facts have not changed in the past few years, as the responses show, something basic has changed. We find a sea change in the

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growing and increasingly widespread awareness of the imperative need to stop and apply simple structural remedies before going further down the rail merger path.

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II. INTRODUCTION

A. Statement of Qualifications

My name is Tom O'Connor and I am Vice-President of Snavelly King Majoros O'Connor & Lee (Snavelly King), an economic and management consulting company. I have been engaged in the business of economic analysis for more than twenty-five years, beginning in 1973 as an economist with the Interstate Commerce Commission (ICC), predecessor of the Surface Transportation Board (STB). A detailed statement of my qualifications is contained in Appendix A to this statement.

During my career I have served in a range of positions which give me different perspectives on the merger process, its problems and its solutions. These positions include:

- Staff of the ICC, the rail regulatory agency.
- Member of the original USRA team that created Conrail out of the wreckage of six bankrupt railroads
- Part of the management team that operated Conrail
- Part of the railroad trade association team that helped design and implement the Staggers Act and
- Consultant and advisor to railroads and shippers in US, Canadian and overseas transportation marketplaces of varying degrees of deregulation.

Throughout this process, a few fundamental principles have proven true, time and again. The most important of these principles is the importance of allowing the

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competitive market to operate.

Virtually all of the problems voiced in this proceeding could be readily solved by the availability of a fit, competing railroad. The Staggers Act was passed in response to concerns that the rail industry was withering under the hand of regulation. That problem was squarely faced and resolved in the intervening years.

Now a new problem has emerged. Railroad consolidation has advanced to the point at which the most recent two mergers, for all intents and purposes, fell under their own weight. Experienced and skilled railroad people seemed unable to operate one of the oldest technologies, and one they were masters of.

This is a process in urgent need of adjustment. As we shall show in this statement, the key to the remedy is simply to return to first principles and allow the competitive market to operate.

- The most basic requirement is access to the competition:
 - We recommend Limited Open Access; as we discussed in both the Opening and Reply Statements.
- The next requirement is application of a rule of reason in designing and applying such regulatory procedures as might be needed:
 - We recommend Revamping of the Bottleneck Rates Rules.
- The ongoing requirement is to ensure that service is adequate and responsive:

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- We recommend Benchmarking Service and Incentivising its Performance.

B. Summary of the Review of the Responses

In collaboration with BASF, I have examined the issues, including analysis of the record developed at the STB's hearings and the Opening Statement filings. In this section we present our analysis of those issues.

1. Downstream Effects

In addressing the issue of downstream effects, the railroad industry is somewhat split on the issues that should be considered by the STB. The carriers involved in the most immediate merger contend that the STB should maintain its one at-a-time rule or that the STB should carefully define and limit the downstream effects to be addressed by the merged railroads. This position is echoed by the CP which advocates that downstream mergers be considered but not be used as a basis to make a decision in the proposed merger. Some also commented that there is no way to predict if a subsequent merger will be "triggered" or the combinations that would be proposed.

Most of the large railroads took the position that evaluation and consideration of the downstream effects are critical factors in analyzing any proposed merger. They assert that almost certainly additional mergers will be filed as a result of an initial merger filing and approval.

One issue is whether one can predict that a major merger in today's rail market will trigger other consolidations and mergers. One only has to look at history.¹

When BN acquired the St. Louis-San Francisco Railway Company, UP countered by combining with Missouri Pacific and Western Pacific. UP later justified its control of Chicago & North Western Transportation Company as a counter to SP's purchase of The Denver and Rio Grande Western Railway Company. UP has publicly stated that its merger with SP was in response to the BN-ATSF merger.

The same pattern can be seen in the East where Chessie System merged with the Seaboard Coastline and the Louisville & Nashville to form CSX Transportation. In response Southern Railway System merged with the Norfolk and Western to form Norfolk Southern. Railroads resist letting their competitors become significantly stronger without seeking equalizing combinations. This situation is graphically illustrated in the split of Conrail between Norfolk Southern and CSX Transportation. This reactive behavior occurs to maintain competitive parity.

Comment

- It is reasonable to conclude that this reactive pattern, on the part of the non-merging railroads, will continue until the "end game" is reached; resulting in two major transcontinental railroads.

¹ The KCS Opening Comments provided good summaries of the merger history.

- The corollary conclusion is that downstream effects must be recognized.

2. Bottleneck Rates

The bottleneck rate issue generated a range of comments from the railroads including positions such as:

- it is not a merger issue;
- establish contract or common carrier rates in relation to gateways; and,
- bottleneck rates should be allowed to be challenged separately under certain conditions.

Countering the assertions of other railroads that bottleneck rates are not a merger issue, UP clearly illustrated a situation where a movement with a bottleneck rate would be impacted by the merger of two of the potential carriers in that haul (See UP Comments, pages 11- 12). The illustration provided by UP is parallel to the example we included in our opening statement under "Operational Alternatives - Line-Haul Service."

Comment

- UP's proposal falters by seeking to require that market dominance first be proven for the entire movement between origin and destination. This would still deny a shipper the opportunity to challenge a bottleneck rate separately if the balance of the rate is not a contract rate.

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A point worth noting regarding bottleneck rates is that not all bottleneck rates are between origin or destination and a major gateway. Class III railroads or shortlines could establish bottleneck rates to their interchange points with Class I connections. While meeting the criteria of a bottleneck rate, that situation does not necessarily involve a major gateway.

Comment

- Setting aside the consideration of whether or not a gateway is involved in the movement, our recommendation remains to allow the bottleneck rate to be challenged without regard to the nature of the other rates in the movement, i.e. contract or tariff.
- While some railroads appear to have addressed this issue, none put forth a remedy to today's protected nature of bottleneck rates. More is required, as we have shown.

3. Limited Open Access

As we expected, the railroads were unanimous that the issue of access should not be handled under merger proceedings, but rather in connection with the general rules of competition and service issues.

Comment

- In advocating open access on a limited scale, in situations where mergers reduced or eliminated competition, we offered four types of operational

solutions. These were: haulage rights; trackage rights; reciprocal switching and joint facilities. Each of these have been implemented in past mergers to restore competition.

- In addition to operational solutions, we also recommended commercial solutions in our initial statement. Canada has for years operated with a rail duopoly. Two solutions Canada has developed to enhance competition are:

- (1) Interswitching and
- (2) Competitive Line Rates (CLR).

Briefly, Interswitching could occur, when a shipper can access within a reasonable distance of its plant, say 50 miles, a second carrier, which can interchange with the carrier currently serving the plant.² Interswitching enables a rate to be prescribed between the interchange point and the origin or destination.

The second Canadian solution, CLR, applies when a shipper has access to only one carrier at origin or destination and a continuous route between those points is operated by two or more carriers. The shipper must be beyond the 30-kilometer distance Interswitching limit. This mechanism can require the local carrier to establish a rate from origin or destination to the nearest interchange with the

² We note that, when Interswitching has been used in Canada, it has generally been within a 30 kilometer range. We further note that Canadian regulations do not limit Interswitching to this range.

connecting carrier. Though not used to the degree that Interswitching is, its availability alone has enhanced shipper's competitive options in the marketplace.

Despite the fact that the Canadian railroads did not prominently mention these alternatives, other respondents, like us, did note the techniques and recommended them. These mechanisms are in place and working effectively. They have well defined limits on their application, which provides assurances to those who fear broader solutions. And they are quite effective. The duopoly in Canada that resulted in these competitive provisions is not unlike the merger "end game" that is a distinct possibility in the U.S.

Comment

- We recommend adoption of the proven solutions recommended above.

4. Regulatory Merger Oversight

Only one railroad specifically identified an oversight time frame. This was set at five years but no mention was made of it becoming a mandatory requirement. While this time frame is reasonable and in line with our position, we believe that the oversight process should be mandatory and included with the approval of any merger by the STB. This is in contrast with the current situation in which oversight is optionally imposed as a condition of approving a merger.

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Comment

- While we believe that five years is a sufficient time frame for oversight, from the date the merger becomes effective, at the conclusion of the recommended Three Phase Merger Approval Process, it must be made a mandatory function of merger approval. This makes the merging entities aware of the conditions under which they will operate in the post merger environment.

5. Operational Alternatives - Line-Haul Service (Gateways)

The views of the railroads differed in language but were similar in content. They, and virtually all other parties, generally agreed that gateways should remain open if they were:

- merger related gateways;
- currently used gateways; or
- classified as efficient gateways.

Comment

- The dominant theme is to maintain or improve the current situation. All of the major gateways would be affected by the formation of two transcontinental railroads.
- The gateways identified by NS (See NS Initial Comments p.37) as being affected by the formation of east-west transcontinental railroads are the same ones that we identified as being impacted by transcontinental railroads.

We noted no commonly accepted definition of what constitutes an "efficient gateway."

The railroads were vocal in stating that they did not want a return to the so called "DT&I" conditions, where all gateways remain in a pre-merger status. The CN stated that the railroad should be required to propose some form of commitment in maintaining open gateways.

Comment

- Railroads also made the point that in the past the STB and ICC have rejected the position that end-to-end mergers reduce competition through foreclosing connections with independent railroads. However, when those decisions were made, the STB and ICC were not analyzing railroads with operations on a transcontinental level.
- As the railroads quite aptly point out, the situation in the railroad industry is different now and different rules should apply on some issues. We, and they, recommend maintaining existing major gateways as open.
- Given the current number of Class I rail systems and the routing options available to shippers it may not be practicable to re-open closed gateways. This could, and should, change if the competitive options are not strengthened.

6. Operational Alternatives - Local Service

The railroads position on opening terminals to reciprocal switching or operation by a switching carrier was the same as increasing competition in line-haul operations, i.e. it is not a merger issue and should be handled under the general rules on competition and service issues.

Comment

- Again the railroads seek to deflect discussion of increasing competitive options, which we, and most other shippers, believe to be the only sure avenue toward a solution.

In past mergers large industrial switching facilities have almost always remained under the total control of the consolidated rail system. In the UP/SP merger the Houston terminal area was finally operated under joint dispatch with BNSF. The operations in Buffalo, acquired by CSXT as part of the Conrail merger, are now under study by the STB, due in part to the operating congestion in that area.

Prior to the merger the reciprocal switching rights of some railroads were eliminated in Buffalo. Some highly industrialized areas that are also major interchange facilities develop much worse congestion in a post merger environment due to a change in management personnel and the procedure of consolidating the merged operations. Due to the high dollar value of the traffic handled at the facility the consolidated system is often reluctant to relinquish operational control.

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Comment

- We suggest giving reciprocal switching rights to another carrier where this would not impact the switching operations within the location or control of the facility.
- only the inbound and outbound line-haul movements.

- The insertion of a terminal switching operator is another remedy for some situations. This would also release the current owning railroad of the responsibility of switching cars into and out of industries and could permit greater focus on their line-haul operations and service.

- Many of the service problems in the last two mergers can be traced to yards and terminals. These are also good places to build the solution.

7. Pre-Merger Safeguards

The railroads acknowledge that the service disruptions, which occurred in the last two mergers, must not be repeated in future mergers. The suggestions put forth by the railroads call for additional detail in the operating or service plan, as well as the establishment of benchmarks to measure changes in service levels.

The provision of service plans were identified by the various railroads as, "Service Integration Plan", "Merger Implementation Plan", and "Integration Plan". These would have a greater level of detail and include mechanisms to accomplish the following: respond to service problems; identify potential areas of change; establish

benchmark service measurements, and identify potential choke points or problem areas.

Many respondents, including many railroads would establish service benchmarks on both a pre and post merger basis to evaluate the post merger environment. One railroad advocated that service guarantees be in place for the first two years after the effective date of the merger. Some of the benchmarks specifically identified were cycle times and transit times. Provision of the 100% traffic tapes of the railroad applicants was also suggested in lieu of the STB rail carload waybill sample. It was also suggested that the implementation plan be updated as traffic data and operating information become available.

Many suggested that a more searching review of the service plan, performance measures, and service parameters should be conducted by the STB. To aid in this review, one railroad suggested that the STB should hire consultants, at applicants' expense, to evaluate the operating and service information submitted in the application. This is similar to the approach used to analyze and evaluate the submissions provided by applicants on environmental issues.

It was suggested that provision be made for a second stage identification by STB and parties of issues that need to be addressed by applicants. We agree with this suggestion. This is one of the reasons why we proposed our Three Phase Merger Approval Process. Since it seems impossible to do all of the planning in one phase, our common sense solution uses multiple and sequential phases. A final

observation made in railroad statements was that requiring more detail in the operating plan does not guarantee that merger related problems will not occur.

Comment

- The railroads have acknowledged that additional data is required from the applicants in the planning, operational and service areas to reduce the chances and magnitude of service disruptions in all future mergers. This is admirable in principle but for the most part the suggestions lack substance and detail.
- BASF worked with the railroads for more than a year preparing for the NS-CSXT-CR merger. This prolonged and intensive effort was to little avail. It may have reduced, but failed to prevent plant production curtailments and service disruptions. Our conclusion is the existing planning process focuses more on preparation for inevitable service disruptions rather than on preventing those disruptions.
- Not one railroad suggested, as we and DOT did, that all phases of the unified operation should be tested in a real time environment to confirm that they will work when the changeover takes place.
 - This is in contrast to the practice of developing a system and testing it in a localized operating area or a laboratory setting, or not having it ready to cut over at all on the effective date.
 - Our Three Phase Merger Approval Process would solve this problem.

- All of the data systems and operating systems must be in place and operational prior to the merger becoming effective.
 - Otherwise shippers will see a repeat of service problems, lost cars, and mis-routings; the same types of problems experienced after the last two mergers.
 - Again, our Three Phase Merger Approval Process would solve the problem.
- Our initial statement recommended that special attention be given to car tracing and identification functions as well as all the computer and data systems. This is by no means the entire universe of areas that must be given intense attention and scrutiny during the merger process. These are only examples of where potential problems have arisen in past mergers.

Many respondents, including some railroads, recognized that benchmarks have to be established in a pre-merger environment in order to set a base line for measuring service levels and changes that occur post merger.

Comment

- Again, these suggestions, while constructive, did not completely identify which are meaningful in indicating trouble in particular service functions or operational areas. The level at which the benchmarks are to be developed was not provided in the railroads' statements.
- We, and some other respondents including DOT, recommended that these benchmarks should be established for specific facilities and operating segments as opposed to the entire merged system. As the rail systems become ever

larger in operating scope, statistics at the system level are less indicative of operating problems until the domino effect impacts major portions of the merged system. By this time the problem has attained devastating proportions.

- The suggestion to update the implementation plan is a good one. The operating plan included in the application is usually assembled well before the application is filed with the STB. As a result, it has been updated by the applicants as traffic data and operational changes have been incorporated. This information is in a constant state of refinement, as it must be, and the STB usually does not have the latest version available to analyze. Updating this part of the application periodically will keep all parties to the proceeding better informed. We endorse this change as a positive step in improving the merger process.
- We also point out that the Three-Phase Merger Approval Process would take care of this problem.
- Three suggestions provided by the railroads work in conjunction with each other and will improve the quality of the analysis performed on the application. It was suggested that the STB perform a more searching review of the service plans, performance measures, and service parameters. It is widely known that the STB has limited resources with which to evaluate and analyze the monumental amount of data produced in a merger proceeding. The evidence produced during a merger requires specific knowledge and disciplines.
- When future mergers are filed the STB may or may not have the resources for a complete and thorough analysis of the data. With the current staffing level and

pending retirements it is quite possible that the STB may not have the required expertise in-house when these "end game" mergers are filed.

- This sets the stage for the railroad suggestion that the STB use consultants in much the same manner and capacity as the STB now does for environmental issues and analysis.
 - The STB's Section of Environmental Analysis (SEA) works in close cooperation with the consultants and oversees their work to be assured that it meets the requirements of the law, is complete and unbiased.
- We recommend that the STB adopt this approach for analyzing the operating plan, performance measures and service parameters. In conjunction with this one of the railroads recommended that a second set of potential problem areas be responded to by applicants.
 - We concur. This parallels our recommendation of a "scoping order" to be issued by the STB as a vehicle to address questions that had arisen in specific areas during the analysis phase of the application. We also believe that this is a critical element in the evaluation of the operational aspects of the merger process. Issues dealt with and scrutinized prior to the effective date of the merger will alleviate or lessen some potential problem areas.

The railroads both stated and experienced the fact that no amount of detail in an operating plan can guarantee that problems will not occur. The adoption of a phased merger approval process will deal with this.

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Comment

- It is difficult to take issue with the statement that problems may occur because so many areas can cause operating problems. However, what we, and the railroads and other respondents, can do is eliminate as many potential problem areas as possible prior to service failures and disruptions.
- The comments of the railroads illustrate very clearly that they like all the parties that have filed statements in this proceeding want the operations to go smoothly and service to remain within normal limits after the merger is approved.
- The common objective is to assure to the greatest extent possible that the problems experienced in the UP/SP and NS-CSXT-CR mergers are not repeated again.
- In view of the extensive scope of operations that will be covered by the applicants in the next round of mergers, the railroads, shippers and U.S. economy cannot withstand another operational meltdown. The recommendations we made in this proceeding can assist in developing a healthy rail transportation system, which is fair and equitable to all parties.

8. Procedural Time Frame

Very few railroads commented on the procedural time frame that should be used to evaluate future mergers. Only two railroads discussed this issue. The first stated

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that the time frame should be one year from the time the pre-filing notification is received by the STB. The rationale for this time frame is, "...to ensure that shippers, the public and railroads receive the benefits of mergers as quickly as possible,...". A second railroad stated that the time frame should be one year unless it was changed by the STB, based on circumstances of the particular merger under evaluation.

Comment

- In the past two mergers the STB has expedited the time frame to a point that probably contributed to service disruptions.
- The benefits to the shippers and public have not materialized, as promised. In the NS-CSXT-CR merger the effective date was delayed almost one year and major and persistent service problems still occurred.
- We certainly do not want to see a repeat of the "Rock Island" situation, but setting a fixed one year time frame in view of the operating scope of future mergers would also be a mistake.
- The STB should set a procedural schedule after review of the notification to file and allowance of adequate time for the filing of potential transactions by competing railroads. This type of approach also demands that an outside time limit be set.

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- We recommend that a two-year time frame be used as an outside limit, and that this be shortened by the STB only when the circumstances of the proceeding allow. Adoption of the Three Phase Merger Approval Process can help fine tune the time requirements, which may exceed two years.
- A window for filing by competing railroads also must be established in order to avoid unnecessary delays in the merger process.

9. Inclusion of Canadian Railroads

The positions of many respondents on this issue, including DOT and the U.S. railroads are quite different from those of the Canadian railroads. The U.S. railroads, with the exception of the BNSF, have stated that all data required of U.S. railroads should also be filed for the Canadian railroads. Data such as the operating plans, pre and post merger operational benchmarks, and all data on the combined system should be provided in the merger filings. NS pointed out that, in the BN-CN merger, the merger impact analysis that only impacted Canada would be excluded. BNSF and CN would decide the extent of this data. The U.S. railroads are asking for a full disclosure of data on the combined system.

CP and CN filed somewhat differing views on this issue. CP stated that the STB cannot discriminate against the Canadian railroads. CP further stated that they do not object to providing data on operational changes and competitive impacts. CN states that no special merger rules are required for Canadian railroads. They further point out that ownership of U.S. railroads by Canadian railroads in the past

has not resulted in adverse impacts. They use the IC, GTW and SOO, as well as smaller railroads, as examples of no recognizable impacts. They also state that the issue of "Port shifts" between Canada and the U.S. is not an issue for the STB.

The comments and concerns of the U.S. railroads, excluding the BNSF, reflect the desire to have within the merger filings the complete operating plan, data integration, capital planning, etc. of the combined system. BNSF states that it will be a separate operating unit. However, under one combined corporate umbrella there will be decisions made both operationally and financially that affect the entire combined system and not the BNSF or the CN-IC "units" in isolation.

Comment

- The statements by the Canadian railroads appear to take the position that they are being asked to provide data or materials beyond that required of U.S. railroads within the merger process. The U.S. railroads are only asking that the Canadian railroads provide the same data as any other railroad provides.
- We recommend that the near-consensus U.S. railroad position be adopted by the STB in revising the merger rules. The Canadian railroads should not be treated any differently than a U.S. railroad when involved in a merger proceeding involving a U.S. railroad. There must be full disclosure of all evidence that supports the merger application in order for the STB to render a valid comprehensible decision.

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- The merging railroads should not have the option to decide which data is provided to the STB. We do not believe that the intent of the ANPR was to discriminate against the Canadian railroads in any manner. Moreover, we concur with the DOT thinking and disagree with the statement by the CN that the shifts between ports is not an issue for the STB.
- In our initial statement we discussed the need to require that Canadian railroads provide operating data and financial information on a basis equal to that currently filed by U.S. railroads. As Canadian railroads merge with and form rate and operating agreements with U.S. railroads the need for cost and operating data is becoming more important. If joint line through rates are filed that involve movement on both Canadian and U.S. railroads it is almost impossible to adjudicate a rate complaint filed against that rate. As Canadian and U.S. railroads form more alliances through mergers or marketing agreements this situation will become more common. This situation has already been enhanced as a result of the NAFTA agreement. Even though BNSF states that they will remain a separate unit, the likelihood that joint line through rates will become a more common occurrence is a very distinct possibility.
- CN made the statement that historically no adverse impacts have resulted from Canadian ownership of U.S. railroads. While this may be true, the GTW, SOO, or even the IC do not have impact comparable to that which BNSF exerts on rail transportation within the U.S., and indeed in North America. When this influence is coupled with the subsequent potential of a further merger with one of the

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eastern U.S. railroads we see an order of magnitude increase in potential impact compared to past mergers between Canadian and U.S. railroads.

10. Shipper Remedies for Service Deterioration

The railroads put forth several possible remedies that would be available to shippers in the event that service failures occurred in connection with future mergers. Some procedures even included detailed steps that would be followed and the requirements necessary to invoke the process. The STB's procedures in Ex Parte 628, Expedited Relief For Service Inadequacies, were also offered as the basis for service remedies, stating that the current regulations are an effective remedy available to shippers.

The proposal was made that service standards should be included in contracts that would include financial consequences to the railroad for failing to meet those standards. The railroads are aware that service guarantees are only one of many elements in a contract. The entering of a contract between a shipper and a railroad comes at a price in that for the stated rate the railroad has a guaranteed traffic flow for a set number of years. Some railroads have been reluctant to set tight service performance standards, as competitive Supply Chain management increasingly demands. Others refuse to enter this element into a contract. The BNSF offered to incorporate service guarantees into its private contracts and they will be backed by financial incentives and will contain private enforcement mechanisms. Possible mechanisms were listed as mediation, arbitration or other efficient means.

The procedures suggested involved the arbitration process and a procedure adjudicated by the STB. The arbitration procedure only applies to shippers that have contracts. The shipper must first wait until the merger has been in effect for six months before any action can be initiated. Arbitration is to be concluded within sixty days of the date the arbitrator is selected. Before the issues can be submitted for arbitration the shipper must notify the railroad of the service deficiencies and they have thirty days to improve performance. It is not clear at what point the arbitrator is selected. The contract can be terminated thirty days after the arbitrator's award.

Under this procedure until the arbitrator settles the contract issue the shipper cannot violate any volume guarantees included in the contract without being liable for damages under the terms of the contract, even though the quality of service has been inadequate for a minimum of four months.

Comment

- This is a totally unworkable procedure that will result in the shipper incurring financial damages, service disruptions and lost business while the process meanders along. This same railroad also offered a non-binding arbitration procedure. The benefits to the shipper that could be gained through this procedure are meager indeed. Their efforts would be better spent in trying to arrange alternative transportation. The proposed solution is so weakly structured as to be meaningless. Revamping the parameters for delay and percentage of decline in service could rescue this proposal.

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A proposed remedy suggested by UP requires a fifty percent (50%) increase in service measurements, based on the pre-merger benchmark before the relief can be sought by the affected shipper. The service level has to be deficient by fifty percent for at least sixty consecutive days before the shipper can take any action. After sixty days, the shipper notifies the railroad and they then have an additional sixty days to remedy the service problem.

Only after enduring one hundred and twenty days of inadequate service can the shipper complain to the STB. The STB has thirty days to grant relief. This process consumes approximately one hundred and fifty days or five months before the shipper has any possibility of relief. This procedure, as was the previously discussed remedy, is totally inadequate as a remedy for service problems. The setting of a flat increase in an operating benchmark as the threshold for consideration is the one positive aspect of the procedure.

Comment

- It is not appropriate solely to use an arbitrary percentage, such as fifty percent as a universal threshold for all shippers and their commodities. Those shippers with time sensitive freight may not be able to accept a percentage increase, while others may be able to adjust their production schedules to accommodate this delay. Still other shippers have limited non-rail options and could be shut down by any prolonged loss of service.

- Many shippers that experienced the service disruptions in the last two mergers would have been thankful to have the transit delays top out in the fifty percent range. For many others, fifty percent would be ruinous.
- We note also that many service disruptions are not related strictly to car cycles and transit time. These involve the pickup and delivery of cars at the shipper's plant. Service that is provided to a shipper five days a week and then reduced to three days a week (less than fifty percent) may result in production related and other types of problems. This is especially true when rail car storage at the plant is limited and the availability of empty cars is limited or non-existent.
- Damage occurring to a shipper because of service is based on many individual factors that can differ markedly from one shipper to the next.
- We recommend that the STB adopt some type of small and short lived percentage differential³ between pre and post merger service levels that would constitute "a service disruption" whereby the shipper could avail itself of remedies before the STB, and/or the courts. The definition of the differential needs more work, as UP recognizes.

³ We find it difficult to see how any company facing competition could sustain a 50% loss in production without a similar loss in business. Most shippers face competition. Increasingly railroads seem to lose touch with that reality.

- Transportation contracts between shippers and railroads could include service guarantees as a mandatory term. Such guarantees would be meaningful only if they reflect a competitive situation. One of the railroad comments, in regard to the issue of remedies, stated that contracts not arbitration should be used by shippers to collect damages for service failures. While we agree with this proposal in principle we observe in practice that it is not always easy to get railroads to agree on performance standards during contract negotiations.
- The use of the STB procedures in Ex Parte 628, Expedited Relief For Service Inadequacies, has also been characterized as an effective tool in dealing with service problems. The STB has shown reluctance to impose substituted service and allow other railroads in to operate over lines of the recently merged system. We find that while the regulations may be an effective tool, their implementation by the STB has had less than the desired results solving the service disruptions that have occurred.

11. "Three-to-two" Issues

The railroads' comments did not dismiss the consideration of three-to-two points in future merger proceedings. Almost unanimously they believe that this situation should be considered on a case-by case basis.

Comment

- We agree that this situation continues to exist and would be affected by a merger process. It should be resolved on the particular circumstances of that instance.
- Simply put, very few of these situations remain. And that is part of the problem.

III. SOME THOUGHTS ON MERGER BENEFITS

Many of the initial statements of the larger Class I railroads extol the benefits of merging two or more rail systems. These benefits include: single line service, more efficient utilization of equipment; enhanced economies and product differentiation through increases in length of haul; combining low density routes into more efficient use of capital assets, etc.

These types of benefits should result in lower service costs, lower operating ratios, higher capitalization and other financial benefits. As part of our transportation practice we assist as technical advisers in contract negotiations. When contracts are negotiated the rates offered by the railroads are consistently and predictably lower when inter-modal or intra-modal competition exists.

The point is that productivity and operational gains accruing to the merged system may not flow to the shipper. This is evident in the annual escalation of rates used in some contracts. Many railroads seek a flat percentage increase or the RCAF-U as the basis of the annual increase to the rates. The RCAF-U is the cost adjustment factor that is unadjusted for productivity gains.

Comment

- The real world in which shippers operate is very different from a world in which cost increases are passed through and productivity gains are hoarded. The Supply Chain business model now driving much of the economy is made up of

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business allies and partners working together. We commend this model to the railroads.

- Railroads can be quite reluctant to share with shippers the cost savings gained through productivity. The STB should be aware that benefits to the merging railroads do not necessarily translate to shipper benefits. However, the additional operating costs incurred by the railroads during service disruptions often are now automatically added to the cost base for the purpose of determining a shipper's rates. Under this scenario the shipper absorbs the risk but may miss the reward. A better balance is advisable.
- Many respondents suggested in their initial statements that extraordinary expenses incurred by railroads during service failures should be excluded from the rate base. We agree that the financial penalties incurred by the railroads for managerial errors in connection with a merger should not automatically be passed through to the ratepayers. This same principle would apply regarding excessive purchase premiums paid in connection with mergers. The STB should also address these aspects in the revised merger guidelines.

IV. CONCLUSION

The next round of mergers will almost certainly lead to the final consolidation of the railroad industry into two transcontinental systems. Without clear policy direction from the STB, this duopolized industry will lose its competitiveness and efficiency. Our original recommendations have been reinforced by dozens of respondents, including shippers, government agencies and some railroads. Again we recommend that the STB should adopt three policy options.

The first policy option would increase protection for shippers by permitting them to challenge a bottleneck rate on its own merits without masking the bottleneck rate in the rates and charges for the other segments of the movement.

The second policy option would adopt a range of strategies for increasing access by shippers to alternative rail carriers. These include haulage and trackage rights, reciprocal switching, interswitching, and competitive line rates.

The third policy option would develop and apply meaningful service benchmarks, incentives and guarantees within a phased process as part of the merger review and monitoring process.

We recommend that these options be implemented within a Three Phase Merger Approval Process that carefully and sequentially develops the decision process while preventing again putting the railroads and their customers and the economy at

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risk.

Failure to adopt these and similar pro-competitive policy initiatives, combined with the effects of the final wave of railroad mergers would seriously hinder a wide range of shipper industries and ultimately redound to the disadvantage of the railroads themselves.

The essential test of the regulatory policies is how efficiently and effectively they generate competitive alternatives. If the regulatory policy enables the creation of competitive alternatives, market forces will complete that process and generate mutually satisfactory solutions.

As has been shown in this statement, and reinforced by many other respondents, policy options are now available to the STB which can prevent and remedy the detrimental effects of the coming wave of rail mergers while promoting financial health of the entire supply chain; supplier, shipper, customer and railroad.

I recommend that STB adopt these responsive and effective policy options within the Three Phased Merger Approval Process:

- Corporate Merger;
- Business Merger and
- Operational Merger.

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V. Qualifications

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Experience

**Snavely King Majoros O'Connor & Lee, Inc., Washington, DC
Vice President (1988-Present)**

Mr. O'Connor has more than twenty-five years experience in the transportation industry. His experience includes key and increasingly responsible management and policy positions with government agencies and private industry.

Mr. O'Connor, in recent years has conducted analyses for the Government of Canada used to shape policy for freight transportation transport policy. He also has developed the Master Plan for Management Information Systems and computer facilities to measure, manage and monitor both rail freight and rail passenger transportation for the Bulgarian State Railways, in Bulgaria and the Balkan Peninsula. He has created and managed numerous computerized transport management and regulatory systems and is a widely recognized expert on costing and economics.

Mr. O'Connor has analyzed more than 45 rail merger scenarios and cases. He has provided expert testimony before state and federal courts and commissions in the U.S. and Canada on economic and policy issues. He has also testified as an expert on computerized transportation analytical systems, rail operations, anti trust issues and transportation costing. Mr. O'Connor also has served as an impartial and expert monitor of data and processes at issue in litigation on transportation.

Within the litigation arena, Mr. O'Connor has also conducted management audits of

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railroads, focused on identifying the cause and effect relationships underlying claimed cost incidence. The management audits were directed toward testing the cost basis of bills submitted by major railroads.

DNS Associates Inc., Washington, DC

Vice President (1982 - 1988)

Mr. O'Connor directed and participated in numerous projects including merger analyses, transportation infra-structure analyses, plant and network rationalization and feasibility studies. He designed and implemented mainframe and microcomputerized systems for analyzing rail, truck and barge logistics. The computerized cost systems Mr. O'Connor created are in widespread use throughout the United States and Canada.

Mr. O'Connor also advised the U.S. Rail Accounting Principles Board on the costing aspects of regulatory reform policies. He also provided expert testimony on computerized data bases and cost systems and related rail cost issues before the Interstate Commerce Commission.

Association of American Railroads, Washington, DC

Assistant Vice President, Economics (1979 - 1982)

Mr. O'Connor designed and managed major economic analysis projects. He helped formulate industry economic policy positions culminating in the Staggers Rail Act of 1980. He submitted expert testimony on behalf of the railroad industry in numerous

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cases before the Interstate Commerce Commission and state regulatory commissions. He also appeared regularly in national forums on economic issues.

Mr. O'Connor directed the most significant computerized industry Costing System project in 40 years, URCS, the cost system now used by all major US railroads. He also conducted industry seminars on URCS and related economic issues.

Mr. O'Connor also testified before the Interstate Commerce Commission on the design and application of this pathbreaking rail cost system since adopted by the Commission and the rail industry.

He also directed development and installation of a commercial computerized economic and market analysis system now used by virtually all major US railroads.

Consolidated Rail Corporation, PA

Assistant Director, Cost & Economics (1977 - 1979)

Mr. O'Connor was responsible for all Conrail management and regulatory cost analyses in both freight and passenger areas. He testified before the ICC on the development of subsidy standards now widely used in the US railroad industry. He also finalized the design, and implemented and managed Contribution Simulator and Calculator (COSAC), a computerized internal management economic analysis system at Conrail. The COSAC system uses specific management accounting data to develop economic costs. COSAC replaced earlier systems and was used to guide virtually all transportation management decisions.

Mr. O'Connor also participated in cost allocation negotiations between Amtrak and Conrail on cost sharing of joint facilities on the North East corridor. He initiated and directed profit maximization and plant rationalization programs. He also designed and implemented computerization and improvement of a wide range of economic and cost analysis systems used to manage this multi-billion dollar corporation.

R.L. Banks & Associates Inc., Washington, DC

Consultant (1976 - 1977)

Mr. O'Connor conducted and directed numerous transportation- related projects in the U.S. and Canada ranging from national logistics analyses to site-specific studies. He specialized in costing systems and appeared as an expert witness on such systems in a precedent setting proceeding before a Canadian Crown Commission.

U.S. Railway Association, Washington, DC

Manager, Local Rail Service Planning (1974 - 1976)

Mr. O'Connor developed, computerized and implemented the light density lines cost analysis system, which defined Conrail. He served as liaison with congressional staffs and shipper groups, as well as federal, state, and local governments, and planning agencies. The system he created was a major element in the design and implementation of the streamlined Midwest-Northeast regional rail system. Mr. O'Connor subsequently appeared as an expert witness to present and defend the operation of the USRA costing system.

Interstate Commerce Commission,

Economist, Washington, DC (1973-1974)

Mr. O'Connor served as a staff economist and authored a report analyzing industry investment patterns and ICC regulatory policy, including ICC use of cost evidence.

Education

University of Massachusetts, Amherst, B.A. Economics

University of Wisconsin, Graduate Course Work, Economics

University of Delaware, Graduate Course Work, Business Management

The American University, Graduate Course Work, Computer Science

Professional Organizations

Transportation Research Board

- Former Chairman Surface Freight Transportation Regulation Committee

Transportation Research Forum

- Former President of the Cost Analysis Chapter

National Defense Transportation Association

- Member of Board of Directors, National Capital Chapter

Phi Beta Kappa academic honors society

Phi Kappa Phi academic honors society

Military

U.S. Army; Sergeant, Combat Engineers

Security Clearance

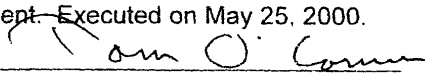
Secret

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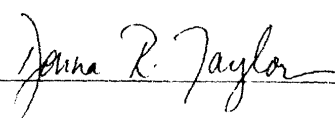
Economic and Management Consultants

VERIFICATION

I, Tom O'Connor, declare under penalty of perjury that the foregoing statement is true and correct and was prepared by me or at my direction. Further, I certify that I am qualified and authorized to file this statement. Executed on May 25, 2000.


Tom O'Connor

Subscribed and sworn to before me this 25th day of May, 2000 in the District of Columbia.


Notary Public

My Commission expires: April 30, 2001

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SK Snavelly King Majoros O'Connor & Lee

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Notice of Service

Copies of this Verified Statement and the accompanying Comments were served by first class mail on the Parties of Record for Ex Parte 582 (Sub No.-1).

Tom O'Connor

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